Robert Schuman Centre

Domestic Responses to Free Trade and Free Finance in OECD Countries

DANIEL VERDIER

RSC No. 98/43

EUI WORKING PAPERS

EUROPEAN UNIVERSITY INSTITUTE

EUI Working Paper RSC No. 98/43

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EUROPEAN UNIVERSITY INSTITUTE, FLORENCE

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BADIA FIESOLANA, SAN DOMENICO (FI)

Printed in Italy in November 1998
European University Institute
Badia Fiesolana
I – 50016 San Domenico (FI)
Italy

ABSTRACT*

For the first time in modern history, free trade coexists with free finance. Free trade and free finance (defined as the deregulation and internationalization of banking and finance) are not mutually reinforcing, but cause a mismatch between the demand and supply of financial instruments - the savers' preference for marketable instruments is increasing at a time when the borrowers' demand for transaction-specific instruments is increasing. This mismatch potentially hurts small firms and local interests most. What can they do about it? It depends on state institutions. The more centralized the state, the fewer opportunities available to potential losers to curb free finance. As a result, free finance is most successful in centralized countries, where resistance to free finance is least strongly felt. This hypothesis is systematically tested on a sample of OECD countries.

* I am pleased to acknowledge the research assistance of Elisabeth Paulet and Benoit Friguet. I wish to thank Dale Murphy, Beth Simmons, and two anonymous reviewers for their comments. Earlier versions of this essay were presented at the Annual Meeting of the International Studies Association, Minneapolis, March 1998, the working group on International Trade at the European University Institute, April 1998, and the Annual Meeting of the American Political Science Association in Boston, September 1998. This research was funded by the Research Council of the European University Institute.

This is not the first time that national financial markets are becoming more global. They reached a similar, if not more advanced, state of mutual dependence during the classic era of the Gold Standard.[1] What is unique about the last three decades of the Twentieth Century is the simultaneity of growing financial openness and freer trade - trade was not free under the Gold Standard. Free trade and free finance are defined as the opening to domestic and international competition of respectively the product and capital markets.[2] In theory, free trade and free finance are mutually reinforcing. Domestic and international competition in finance allow firms to reduce costs of production and meet foreign competition in goods markets. Cheaper goods, in turn, allow consumers to save more, increasing the supply and further reducing the cost of capital. In practice, however, the relation between financial openness and free trade, I argue, is not as virtuous as it first seems to be, but generates a discrepancy. Borrowers want more transaction-specific financial instruments whereas savers want more marketable financial instruments. As a result, financial globalization is not neutral, but has redistributional effects. It has the potential, I argue, to harm the small and the local. Consequently, interests that are potentially losing from market dynamics face two options. They may defer to market forces; or they may resist such forces, lobbying for regulatory protection to keep globalization in check. Which option do they typically choose?

This question is central to the literature on financial globalization.[3] A first wave of studies announced that financial globalization benefited large multinational companies and other transnational actors at the expense of the state and, thus, of interests that exclusively rely on national political representation to defend their rights.[4] A second wave found that the opposite was actually occurring; that globalization, to paraphrase Alan Milward's felicitous formula about Europeanization, "rescued the state." States used financial deregulation - and the associated re-regulation at the supranational level - to claim the regulation of activities until then the competence of local governments and professional organizations.[5] With state power thus intact, financial internationalization should be, according to this approach, unlikely to proceed at the expense of state-dependent interests.

The present work offers a more nuanced view of reality. Current data show that OECD countries are not equally involved in financial globalization.[6] I intend to explain this variation in terms of political coalitions and political institutions.[7] I model financial globalization as a market outcome, shaped by a non-market process - lobbying for a government policy. The analysis rests on a dynamic model, featuring, to keep things deliberately simple, a two-period

decision process. In the first period, the government is confronted with an exogenous trend (be it a technical innovation, a fashion, or else) that promises to ease internationalization in the second period if the trend is allowed to proceed. If so allowed, the degree of openness of the capital market will be higher in the second period than in the first. If the trend instead is checked, the degree of openness will remain unchanged. The potential trend toward globalization has distributional consequences that actors anticipate and for or against which they mobilize according to whether they expect to win or lose. The institutional makeup influences political competition between the two camps. State centralization makes the potential winners of globalization the likely winners of the political competition. Decentralization, in contrast, gives an edge to the potential losers. The political competition determines the policy outcome, and the policy outcome determines the market outcome - the relative market share of each camp, the relative importance of markets in the financing of investment, and the degree of dependence on the world financial market. This is a rational-expectations model in which all variables but one - state institutions - are endogenous.[8]

The present study makes three related claims. First, the joint trends toward free trade and free finance have the potential to cause a mismatch between the demand and supply of financial instruments. Second, this mismatch threatens to hurt small banks, small firms, and local interests most. Third, free finance (holding free trade constant), is more likely to obtain in centralized countries, where the potential losers of globalization tend to be politically weaker, than in decentralized countries, where these potential losers are politically stronger. The study systematically tests aspects of each claim against various subsets of OECD countries.

The first three sections develop the argument that current trends in finance and trade cause a mismatch between the demand and supply of financial instruments. The fourth section develops the territorial effects of free trade. A fifth section maps the potential winners and losers, and a sixth, the losers' nonmarket options. The penultimate section derives testable hypotheses and confront them with OECD reality. A concluding section recalls, and expands on, the findings.

Transaction-Specific and Marketable Financial Instruments

Capital can be allocated in two analytically distinct ways. Capital can be allocated through an efficient spot market, characterized by little information asymmetry between lenders and borrowers and in which neither side controls

prices. Alternatively, capital can be allocated through a network - a long-term relationship enforced by institutional, social, cultural, or mere reputational devices. The long-term horizon of the network relationship makes possible the transfer of private information from the borrower to the lender; it also prevents the lender from indulging in monopolistic pricing, as each side is deterred from short-term opportunism by the desire to preserve the long-term relationship.

Two types of lender-borrower network are encountered in OECD countries. A first type is the classic German model of universal banking, in which bank and firm are engaged in a long-term, oligopolistic relation with each other. One bank serves all the financial needs of its clients "from cradle to grave." Bankers play an active role in the management of the firm, and use their financial clout to help firms belonging to the same sector cartelize that sector.[9] Information asymmetry and rent seeking are minimized, because bank and firm owners are socially close, and because the bank's future business relies entirely on the success of its clients. Roughly equivalent versions of this model are the Japanese "Keiretsu" and the French "Groupe," featuring cross-shareholding among a handful of firms that are involved in various sectors and are clustered around one bank.[10]

The second type of financial network is the Italian industrial district, also present in various forms in other countries. The industrial district, is a network of small, low-capitalized, and versatile enterprises, working together to spread risk, offer a greater diversity of products, and maintain a skilled workforce.[11] Firms in industrial districts rely on local municipalities, guilds, and trade associations to supply them with the necessary externalities - vocational training, price and wage regulation, marketing facilities, quality normalization. Capital is typically supplied by one or two local banks, usually nonprofit, such as a savings bank working in association with a credit cooperative, each enjoying a local monopoly. Information asymmetry and rent seeking are minimized because of community ties, geographic proximity, and the dependence of bank's profits on the district's fortune.[12]

Financial instruments used in market-mediated transactions are by definition marketable. The price reflects the true value of the investment; any saver can purchase it. In contrast, financial instruments used in network-based transactions are transaction-specific; the price includes information that is only known to the parties to the transaction. The resulting financial instrument (a loan, for instance) has no, or less, value outside the two parties - it is not marketable.

A marketable instrument offers the advantage of being easily disposable. The liquidity risk that is borne by its holder is virtually nil, since, short of a market crash, there exists a second-hand market on which the instrument can be immediately sold off. A transaction-specific instrument, in contrast, cannot be liquidated, except at an unreasonable loss, but must be held until maturity. The liquidity risk of a transaction-specific instrument is thus high.

Neither instrument is a priori superior to the other. On the one hand, markets are unable to gather and transmit information when one side of the contract has both an interest in, and the possibility of, hiding information, or when either side manipulates prices. Networks, in contrast, give lenders (banks usually) access to private information because their relations with borrowers are long-term and impregnated with reputation and personal trust. On the other hand, markets are more efficient at pricing products for which there exists sufficient information or guarantees, provided that these products occur in high volume. In sum, marketable and transaction-specific instruments are specialized instruments; marketable instruments are good for financing the known and numerous, whereas transaction-specific instruments are better adapted to the less visible and more qualitative.

What matters is that the relative supply of each type of instrument matches the relative demand. I argue that the twofold trend toward free trade and free finance causes a mismatch - free finance increases lenders' supply of marketable instruments, whereas free trade raises borrowers' demand for transaction-specific instruments.

Free Finance and the Declining Supply of Transaction-Specific Instruments

A greater proportion of financing is done across borders today than in 1960. A greater proportion is also done through securities markets than through bank lending and borrowing (this second trend is commonly referred to in the specialized literature as "securitization" or "disintermediation").

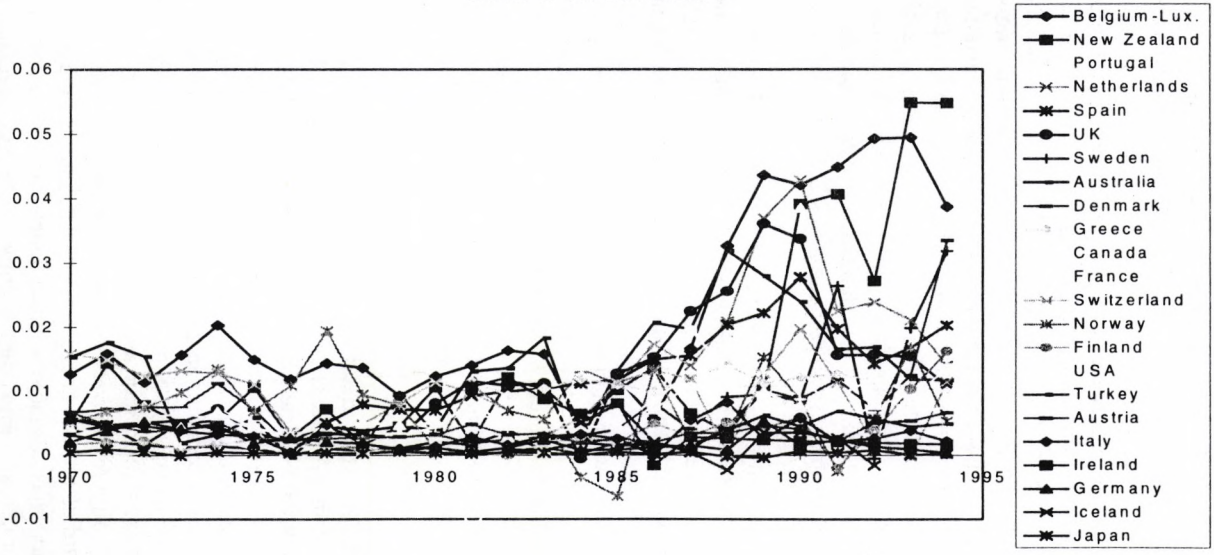
The trend toward free finance started with the opening of the "Euromarkets" in the 1960s. Euromarkets developed free of bank reserve requirements and interest rate regulation, and were used by large banks throughout the world as a means to evade the vicious squeeze to which they were subject at home by governments intent on keeping interest rates artificially low to promote home investment while using bank reserve requirements to contain inflation.[13] Simultaneously, commercial banks

successfully lobbied for the loosening of the interwar regulatory straitjacket, which restricted their activity to short-term lending. They had the support of their respective central bank, who grew disturbed at the negative impact of the commercial banks' decline on the efficiency of monetary policy, of which the banks served as conduit. The tax cuts that sanctioned the neo-liberal reforms of the 1980s forced state treasuries to finance their growing debt on the bond market. To ease the financing of the debt, treasuries pursued deflationary policies, thereby reviving the moribund bond market for corporate borrowers at the expense of bank lending. The privatization of state-owned companies in European countries then led governments to promote stock markets, passing legislation making the purchase of securities more attractive to households. The ongoing privatization of pensions plans in some OECD countries, associated with a deep-seated ageing of populations, is responsible for the growing assets of insurance companies and pension funds.[14]

Faced with disintermediation - that is, the replacement of loans and deposits by securities - commercial banks (along with savings banks) successfully lobbied for a piece of the securities business. The separation between commercial banks and securities houses was abolished in France, Belgium, Sweden, and Italy. Still on paper in the United States, the Glass-Steagall prohibition was partially emptied from its content by the FED during the 1980s.[15] Moreover, following Wall Street's "Big Bang," stock-market rates and membership were freed almost everywhere in OECD world.[16] In all cases, entry was also extended to foreigners. More recently, some governments have opened the insurance market to banks. In a majority of OECD countries, financial institutions already enjoy the right to sell the mix of financial products they want.

Although unmistakable, the trend toward internationalization and securitization is not universal. A glance at FDI inflows weighted by GDP shows a longitudinal increase over time for some, but not all, OECD countries (see Graph 1). But before I venture to explain this rising divergence, I need first to explore what the distributional effects of free finance are. I argue in the remainder of this section that internationalization and securitization have two negative consequences for banks: (1) they raise the level of competition, reducing profit margins; (2) they increase bank vulnerability to market volatility. Banks do typically respond to this dual threat by embracing a strategy of product standardization and amalgamation. This move, though quite functional for the banks, has negative consequences for investors and borrowers at large, as it cuts into the supply of transaction-specific instruments.

GRAPH 1:**FDI Inflows**



Data Description: FDO inflows weighted by GDP.
Sources: 1970-1981: OECD 1987, pp. 60; 1982-1983: OECD International Direct Investment Statistics Yearbook, 1994, pp. 13-14; 1984-1995: OECD International Direct Investment Statistics Yearbook, 1996, pp. 13-14.

Competition eliminates rents, putting a downward pressure on bank profit.[17] Banks cannot easily resort to product diversification to restore (or prevent the compression of), even temporarily, their profit margins. There are few R&D rents in banking. As Tony Porter (1993: 93) writes, "new products mature and bank hierarchies are being replaced with arm's length transactions in these instruments... A wholesale market in swaps has developed, promoted by investment banks, and was so successful that everyone joined in." Only the high end of investment banking is escaping the commodification that has followed the commercial banks' entry in securities markets - the highly personalized businesses, such as very large stock and bond flotation, private placements, cross-border Mergers and Acquisitions, and designer-driven derivative products, to name a few. Such is the reason why the large commercial banks have been acquiring well-known investment banks.[18] This is where the personalized and lucrative deals still are. There is limited room at the top, however.

A second source of concern is real interest rate volatility. With households seeking the higher (in the long-run) returns of securities markets, banks are no longer able to finance their activity through deposits alone, but must also borrow on the international money market. So doing, they are subject to interest rate volatility, which, contrary to monetarists' predictions, has increased since markets have been allowed to set interest rates. They also have to worry about their credit rating, which determines the price they pay. Banks, therefore, have a growing preference for assets that are easily disposable, not only to be able to unload them in case of interest hike, but also because disposable assets have a market value that is directly - and more favorably - assessable by Moody's and Standard & Poor's.

Banks can logically respond (and, in many cases, have actually responded) to the twofold threat of losses and volatility by pursing a strategy of product (asset) standardization. Asset standardization makes bank assets less risky and more valuable, for more easily disposable. This explains the recent success of "asset-backed securities," by which banks "securitize" some of their loans. Banks typically collect a large portfolio of bank loans that are then used as collateral for new bonds. It works because markets can price certain bank loans better - and thus higher - than single banks, provided, first, that these loans occur in large pools for which past experience can be used to predict default rates and, second, that claims over collateral be easily transferable. Only a few categories of bank assets so far meet these requirements; they are credit card receivables, corporate receivables, automobile loans, mortgages, leases, and home equity loans.[19]

Standardization decreases information requirements, thus making mass-production - the processing of a high volume of instruments at paper-thin profit margins - a viable strategy. Banks typically increase volume by expanding their existing distribution networks, mostly through acquisition, due to the large fixed costs sunk into branch networks.[20] Bank amalgamation increases the deposit and retailing base of the bank, improving its placement facilities and enabling it to play a role in the largest and most profitable issues, international especially. There are indeed substantial scale economies in investment banking, the cost of a large issue being no significantly higher than that of a small issue.[21]

Although quite functional from a banker's perspective, bank concentration and asset standardization have negative implications for market efficiency. Bank concentration and asset standardization eliminate the comparative advantage that banks have over markets in overcoming information asymmetry. Recall from the first section that the long-term character of a relationship between a bank and a firm is what allows the bank to reduce the information asymmetry otherwise typical of contracts in which one side has an interest in hiding information. As banks become more dependent on securities markets, both to procure resources and dispose of assets, they have an incentive to neglect loans that are firm-specific, illiquid, and that should invariably drag their credit ratings down. Indeed, relational information (the private information that a bank is able to gather on a firm through a long-term relationship with that firm) does not readily transfer to other creditors, thereby making these loans' market value - the only value that Standard & Poor's fully recognizes when rating a bank - systematically inferior to their real value.[22] Banks also have an interest in eliminating past cross-subsidization between large and small loans. Finally, the trend toward bank concentration makes monitoring through physical presence at board meetings impractical for the small and medium-size firms, for bankers are able to attend only so many board meetings in a year, preferably those of the largest companies.

The banks' lesser capacity to reduce information asymmetry is not compensated by a greater aptitude of markets to do so. Improvements in information technology may facilitate the dissemination of public information; more information may be available on borrowers for whom there is information to begin with. But they do little for the gathering of relational information. There is no one else, besides bankers, to monitor firms. Institutional investors typically hold highly diversified portfolios with small stakes in hundreds of companies for short periods and are thus unlikely to

assume that role.[23] Credit-rating institutions such as Moody's and Standard & Poor's are not designed to gather relational information.

I have argued that free finance is likely to cause a surge in competition that would make the financial sector less able to supply transaction-specific instruments to the non financial sector. This proposition can be tested. Testable too is the related proposition that the banks that are best able to take advantage of securitization and internationalization (e.g., the largest banks) are likely to grow relative to those that depend on local, small business. These two propositions will be tested when the entire story is told. In what follows, I explain why the declining supply of transaction-specific instruments is unlikely to be matched by a declining demand.

Free Trade and the Rising Demand for Transaction-Specific Instruments

Free trade increases competition among firms, cutting into their profit margins and forcing them to develop a competitive advantage. Competitive advantage can be had in the form of either lower costs or differentiated products that command premium prices. Cost-cutting through process change, subcontracting, sourcing factors abroad, flexible wages and working hours can only offer temporary relief to a handful of pacesetters, before teeing off a new - and stiffer - round of price-cutting. Product differentiation is a more sustainable strategy.[24] Product differentiation is an attempt to carve a niche in a given product market, which the firm then tries to corner and exploit to restore its profit margin. Ways of doing so range from cosmetic repackaging to actual innovation, with the latter being more effective. But even product differentiation only allows the successful firm to achieve no more than a temporary advantage, lasting the time it takes for competitors either to replicate or overcome this advantage. The profitable firms are those that are flexible enough to produce a large and continuously changing panoply of products that markets want, in large quantity, at low cost, within (and for) a short amount of time.

The present trend toward product differentiation (and flexible production) is to be contrasted with the emphasis on mass production that obtained in the oligopolistic and protectionist markets of the past. Organized around the production of "long runs" of a handful of products, mass-production firms proved unable to retool cheaply and timely. New forms of organization have emerged to match the new requisite of flexible differentiation. One of them is the industrial district, already mentioned.[25] The other "fittest" is the so-called "network firm." It is the dis-integrated version of

the old large company, composed of the equivalent of a lean holding company dealing with its subsidiaries as if they were independent subcontractors.[26]

The shift toward networking, common to small and large firms alike, reflects the fact that market differentiation through product innovation (and flexible production) is both costly and risky. R&D costs have a steep fixed component, while returns on R&D are both probabilistic and afflicted with externalities - they diffuse rapidly.[27] Fixed cost, probabilistic returns, and externalities are three good reasons for firms to diversify the portfolio of products containing the same technological know-how. Rather than building larger research departments, firms are more inclined to spread risk with other firms and local governments.[28]

Networked or not, however, today's firms, unlike their ancestors, have a *continuous* need for external capital. They cannot establish market power by sinking capital into physical assets that can be used as partial collateral, but instead invest in disembodied knowledge, void of market value, unusable as collateral, and which can only be financed by owners (through retained earnings or through the issuance of new stocks) or by members of a common network. Firms cannot raise most of their risk capital on their own through monopolistic pricing, but instead are in a much greater need of an external source, on which they can rely if, for whatever reason, their capacity to extract rents momentarily fails to deliver the sums that are needed to stay in the race for new products.

Hence, free trade forces firms seek to do the same through product diversification (and flexible production), at the same time that free finance forces banks to regain a competitive advantage through product standardization (and concentration), causing a potential mismatch between the relative supply of, and demand for, transaction-specific instruments.

Can't this mismatch be solved through the price mechanism? One could imagine that the excess demand for bank loans would push interest rates upward enough to re-launch bank intermediation. Simultaneously, if too much savings are chasing too few securitized assets, profit margins on such instruments should fall below a point where it would become profitable for banks to invest in unsecuritized debt. Surely, no trend away from equilibrium is sustainable in the long run; there is always a point past which an adjustment must occur. Where this clearing point lies is unknown. What is certain, however, is that this clearing point will have to clear more than the lender-borrower market. It will also have to clear the political market. For as long as governments are bent on encouraging households to switch their savings from

bank accounts to security funds, banks will have a vested interest to prefer marketable paper to intermediation. Similarly, as long as governments are bent on lowering trade barriers, product markets will grow uncertain, forcing small companies to adopt ever riskier financial arrangements. Adjustment may take a form other than a change in the price of financial instruments; bankruptcy and industrial concentration are possible alternative.

In the next section, I consider a related, yet analytically distinct, effect of free trade - agglomeration.

Free Trade and Economies of Agglomeration

There is an emerging consensus across disciplines that modern production has a territorial, local dimension. Michael Porter writes that "more open global competition makes the home base more, not less, important."[29] Paul Krugman shows, in contrast to the prevailing assumption that the decline in transportation costs makes firms indifferent to localization, that it makes them want to agglomerate.[30] It is a fact that multinational firms locate their most advanced technological capacities in their home countries.[31] Students of flexible specialization stress the importance of geographical concentration in attracting talented people and the role of proximity in the production of learning and innovation.[32] As Ash Amin and Nigel Thrift put it well, "the world economy may have become decentralized, but it is not necessarily becoming decentered."[33] In sum, firms' greater reliance on knowledge-based assets, also a consequence of freer trade, creates economies of agglomeration.

Economies of agglomeration potentially have severe redistributional consequences for local districts. Those with an already dense industrial base may see it further reinforced, while those with a weak one risk to lose what they have, and those without any might remain barren. The most favored areas are those located around large metropolitan regions. Big cities, according to Tödtling, "still have superior locational conditions such as good transportation and communications networks, high levels of education, large number of research institutions, and highly qualified labor."[34] Less favored are the industrial districts located at the periphery.

Potential Winners and Losers

So far, I have sketched a global trend, paying no attention to cross-national variations. It is now the time to ask why some countries, Germany for instance, are resisting financial globalization. The answer, I argue, is that the expected redistributional consequences of financial globalization are causing potential losers to lobby against it. But not all potential losers enjoy the political power to mount a successful blocking campaign. I will establish a map of potential losers and winners in this section and then address the power issue in the next section.

What is the most appropriate way of categorizing interests - along factor, sector, size, or geographic lines?[35] It is generally assumed that financial globalization favors capital at the expense of labor because it makes capital relatively more mobile than labor.[36] Yet, financial globalization does not pit capital against labor. Capital exists in two forms - saved and vested. It is saved capital that financial globalization has made more mobile by extending its range of action from the nation to the world. But once invested in buildings and machines, capital is hardly more mobile today than it was thirty years ago. Owners of vested capital, be they small entrepreneurs or loyal stockholders, are as much in need of attracting liquid capital than labor is. If they have the wherewithal to raise funds in global markets, they are likely to embrace financial globalization. If they instead are tightly dependent on bank loans, they are likely to blame their financial difficulties on globalization.

Surely, firms enjoy greater latitude to contain wage pressures than in the past. They can threaten to relocate production in wage heavens - the famous "giant sucking sound" that Ross Perot attributed to the North American Free Trade Agreement. This real difference, however, is not so much the consequence of financial globalization than of product globalization - free trade - which makes outsourcing possible. More importantly, one must be careful to differentiate workers according to skill levels. Skilled workers benefit from free trade, for free trade compels firms to strengthen their R&D departments and build the quality circles that are a prerequisite to the successful pursuit of product differentiation.

Financial globalization does not reinforce, but breaks sectoral solidarity. Financial globalization discriminates between firms that have the capacity to finance innovation on their own or by borrowing on capital markets and firms that are dependent on bank loans. The former tend to be large companies, the latter, small- and medium-size companies. Free finance does not necessarily

favor banks at the expense of non-financial sectors either. Banks handle greater volumes, but at lower profit margins.

Financial globalization should pit borrowers against savers. In creditor countries, free finance opens up new investment opportunities to domestic savers, while forcing local borrowers to compete with foreign borrowers and remunerate external capital better. The situation is the exact reverse in debtor countries. However, the saver-borrower cleavage offers little edge on the countries included in this study - the advanced subset of the OECD club. With most foreign investment occurring between these countries and most of these countries importing as much capital as they export, it is impossible to say without ambiguity whether financial globalization favors savers or borrowers.

The most relevant cleavage, I argue, is the core-periphery cleavage, pitting a center populated with a few large players against a periphery constituted of smaller actors. The core-periphery cleavage is a composite of two analytically distinct dimensions - size and territory - reflecting the joint impact of free finance and free trade. Free finance benefits the big at the expense of the small. Among banks and financial companies, the uncontested winners are bound to be the commercial banks. Surely competition is increasing for them as for everyone else, but so are the stakes of competition. New fields of activity are being opened up in all venues of finance, allowing the commercial banks to restore their prior market shares. Institutional investors, notably investment and mutual funds, should also be obvious winners. In contrast, all the banks that benefited from the postwar regulatory apparatus (nonprofit banks, state banks, local banks, and securities houses) are slated to lose. Not all commercial banks should benefit equally, though, as the commercial-non-commercial line of cleavage is bisected by another, pitting large against small financial firms. Small commercial banks may end up absorbed by larger ones, whereas a handful of large securities houses and investment banks of high repute also have the means to buy commercial banks. Large size in finance unequivocally translates into central location. Large banks are headquartered in financial centers, along with security houses, brokers, and institutional investors.

In the case of non-financial corporations, it is size also that is likely to determine the relative gains and losses from free finance - the potential winners are the large firms, whereas the losers are the small and medium-size companies. The latter are firms that are too large to expand on the sole basis of internal funding (the owners' wealth), yet too small to enable market investors to evaluate their earning potential with a modicum of confidence; they must instead rely on bank loans. The trend for banks, however, is to move away

from small-business loans, because such loans are transaction-specific and are unmarketable.[37]

Small-firm districts are threatened because small firms in general are threatened, and also because economies of agglomeration favor more concentrated at the expense of less concentrated regional economies. Furthermore, deregulation and unrestrained competition are harmful to industrial districts. Jonathan Zeitlin argues that industrial districts depend on public goods (vocational training, price and wage regulation, marketing facilities, quality normalization, and access to capital) which are not provided by market mechanisms.[38] In his study of Britain, Zeitlin points to the disappearance of regional banking as a cause for the disappearance of small firms and industrial districts.[39]

Table 1 recapitulates the potential distortions associated with the mounting competition in financial and product markets. The winners tend to be the big and the centered; the losers, the small and the local. What emerges from Table 1 is a three-tiered center-periphery model of distribution of gains and losses. The financial center is home to profit center banks and large securities houses, institutional investors, and large firms, all potential winners of free trade and free finance. A second tier of regional industrial centers is home to large firms and densely-populated metropolitan regions, financed by a mixed group of center-bank branches and local banks. What this intermediate tier could potentially lose to the center, it could recoup it from the tier below. The third tier is essentially composed of potential losers, including local banks, savings banks, cooperatives, and traditional small-firm districts.

TABLE 1
Potential Winners and Losers
from the Growing Competition in Financial and Product Markets

	WINNERS	LOSERS
FINANCIAL SECTOR	large center profit banks, institutional investors, large securities houses	savings banks and coops, mortgage banks, small investment banks, small securities houses
NON-FINANCIAL SECTOR	large firms urban centers	small firms industrial districts at the periphery

The Potential Losers' Nonmarket Options

The potential losers are not necessarily condemned but have a choice between two options: (1) they may defer to market forces, take a loss, and reinvest what is left into a winning line of business. For instance, many savings and mortgage banks in Australia and Britain, including the British Post Office savings bank, have forsaken their non-profit status to become commercial banks or subsidiaries thereof.[40] In the same vein, the privatization of savings banks and Länder-owned *Landesbanken* has been debated in Germany. The effect of privatization is to re-orient the bank activity away from the local economy toward the national and world markets.[41] (2) Alternatively, the potential losers may decide to challenge the verdict of the market in the political realm and seek state protection for their existing business. What the potential losers choose should depend on the relative expected costs and benefits of each option, a calculation that should also include the potential winners' possible counter-responses.

Political parties do not figure among the political channels available to potential losers. With perhaps the exception of the United States, all party systems in OECD countries were formed during the interwar and immediate postwar periods at the peak of the class struggle. Today, these party systems are still cleft by the class cleavage - the moderate right is less dependent on unionized labor support than the moderate left. Yet, as I argued in the prior section, the class cleavage offers little grasp on the redistributional issues triggered by financial globalization. In practice, the European Left is as much supportive of financial globalization as the Right.[42] There is a centripetal consensus (not shared by the partisan extremes) that redistribution ought not to interfere with market efficiency in general, and with financial market efficiency in particular. This does not mean that the Left-Right partisan conflict is absent from the globalization debate altogether, only that its focus is shifted from the issue of resistance to that of indemnification. The Left may be better able to indemnify the losers of financial globalization than the Right, but equally willing to let them lose in the first place.[43]

Although neither the working-class Left nor the capitalist Right may see themselves as the natural champions of the claims expressed by the small and the local, it may be that the sheer electoral size of that grouping would be sufficient to entice both the Left and the Right to court their support by articulating the antiglobal rhetoric. This does not seem to be the case, however. Paradoxically, the very decline of the class cleavage has weakened the electoral power of the small and the local. The alignment of the Right-Left partisan fight along the worker-capitalist cleavage some hundred years ago

created unique opportunities for groups without prior affiliation to either of the two main protagonists. In many countries, farmers boosted their market fortune by forming iron-and-rye coalitions with capitalists in the late 19th century and then red-green coalitions with the Left from the 1930s on. Artisans, small merchants and manufacturers, and workers on their own account were also coveted by the Right to fight the political battles of big business and by the Left to stem the tide of nationalist, anti-democratic movements. More generally, partisan polarization thinned the ranks of the unorganized median voters, thereby enhancing the intermediate groups' leverage. In the last decades, however, de-industrialization, the embourgeoisement of the working class, and the weakening of trade unions and other intermediate groups have weakened the class cleavage and turned electoral politics into a specie of Downs' (1957) median voting model, with voter normally distributed, a sizable floating vote, and policy convergence around pro-market policies. The electoral leverage previously enjoyed by the small and local bourgeoisies was diluted. The small and the local lost their strategic position at the center of the political spectrum. The only national parties to be responsive to their antiglobal plea, today, are populist parties - the French *Front National*, the Austrian Freedom Party, the Norwegian Progress Party, and the Australian One Nation Party, to name a few.[44] These parties have racial, extremist overtones that condemn them to remaining in the opposition - a rather unattractive option for small firms and small districts looking for concrete measures.[45]

Like political parties, national trade associations are equally unlikely to articulate the local banks', small firms', and small districts' concerns. With regard to banks, the end to the mandatory specialization of intermediaries by maturity, type of business, and location, allows financial institutions to sell products in all financial sectors (commercial, savings, mortgages, securities, and insurance), thereby causing the largest players in each sector to engage in cross-sectoral diversification and defect from past sectorwide strategy. With respect to non-financial firms, national trade associations are good at lobbying for policy ends that are shared by all ther members of a given sector, such as tariffs, NTBs, or sectoral subsidies. They are unable to deal with the divisive issue of financial globalization.

Central government agencies are also unlikely to be responsive to the small and the local's pleas - assuming, of course, that those scattered groups could act collectively at such a centralized level. Most of these agencies gain from financial internationalization. The growth of the domestic and international bond markets provides treasuries with the possibility of refinancing the public debt at optimal conditions, nowadays that central banks are independent and monetary policy is no longer used to maintain artificially

low interest rates. Also, deregulation has freed the regulatory agencies of the central government from past capture by professional associations and local agencies.[46] In the field of banking, de-segmentation allowed the banks' regulator, the central bank (the FED in the United States), to extend its regulatory authority to the entire banking sector. Central government agencies are the obvious allies of the potential winners of globalization.

Rather than central political institutions (parties, national trade associations, and government agencies), the potential losers of financial internationalization are more likely to turn toward subnational levels of government. There are two main reasons. First, political success requires collective action, which, for scattered groups, is more plausible at the level of the local government than at the national level. Second, most local governments oppose free finance. With perhaps the exception of those that host large companies, local governments tend to lose from a financial globalization that increases the centralization of financial markets and dispossesses local agencies from their regulatory powers. Free finance reduces local control over local resources.

Not all local governments are evenly apt to make the nonmarket option attractive to the small and the local, however. This is especially so in countries with traditionally centralized state institutions, in which local governments have no representation of their own and are no match to central agencies. The situation is different in decentralized systems, in which the legislative branch of central governments is often bicameral with one of the two chambers structured to represent local governments or local citizens *qua* local citizens. Local governments in decentralized systems have the power to veto deregulation or force a compromise recognizing their claims. This is true both at the national level and, in the case of the fifteen OECD countries that are part of the EU, at the EU Council and Commission level.[47] What local governments cannot do is check deregulation through the market or the courts.[48]

Two additional traits make lobbying local governments in decentralized countries by the potential losers of free finance worth their while. Only in decentralized states, first, do we find local governments already enjoying a well-supplied local financial market. Having something to defend makes the veto power a more effective tool than if new legislation was required. Local governments in decentralized countries can achieve their political goals by threatening merely to freeze the regulatory status quo - the tax and regulatory privileges enjoyed by the nonprofit and local banks, the obstacles to inter-regional and international branching, the curbs to competition among regional stock exchanges.[49] A more pro-active stand involves chartering a local state

bank, which, again, only governments with a tradition of intervention in the local economy can manage to accomplish.

Second, local governments in decentralized countries are better able than their equivalents in centralized countries to circumvent - not solve - the problem of information asymmetry and attract outside capital. Generally, center banks will be more apt to overcome their aversion for lending to companies on which they have limited knowledge if they can secure some form of government guarantee against an eventual default. This guarantee may vary from a formal commitment by the central government to bail out defaulting borrowers, a covenant that is very difficult to extract, to a simple political pledge of not letting local economies down in a period of crisis, a promise that local politicians are usually quite willing to extend. In a centralized country, in which local economies are traditionally weak and a large section of small and medium-size enterprises quite often exist at the sufferance of the central government, the center banks will request no less than a formal guarantee from the central government before lending to small and local business. In a decentralized economy, in contrast, where small- and medium-size companies are plugged into local political networks, and in which local governments collectively exercise power in the central government, the need to extract such a guarantee for a bank is less pressing. The defaulting firm will be bailed out by the local government, and the fiscally-constrained local government in turn will receive help from the central government. In such a case, an informal commitment will prove generally sufficient both to encourage center banks to lend to local business and compromise these banks' preferences for all-out globalism.[50] Hence, one would expect the potential winners of globalization to be both less capable politically and less willing economically to pursue all-out globalization in decentralized than in centralized countries.

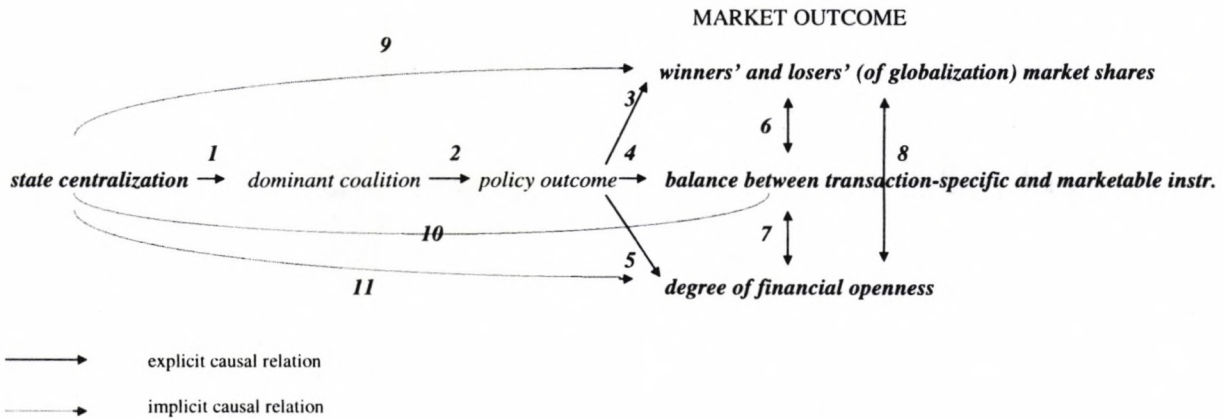
Summing up the argument, potential losers have a chance of stalling, or at least retarding, the trends that they anticipate to be harmful to them only in decentralized countries. Local governments in decentralized countries enjoy the requisite wherewithal's: they have the regulatory and political power to defend local resources from being drained away to the financial center and therefrom to foreign markets; they also enjoy greater implicit political guarantees, leading center banks to lend to small firms to a greater extent than what open market relations would allow otherwise. In centralized countries, in contrast, the potential losers stand no chance to block a trend that has the support of the largest banks, firms, big cities, and the central government treasury at the very least. The theoretical claim is thus that governments in decentralized countries should be more likely, comparatively speaking, to pursue a policy of *selective globalization,* accepting globalization fully in

product markets but only partially in financial markets, whereas governments in centralized countries should lean toward *all-out globalization.*

Hypotheses and Evidence

The underlying model may be restated. The institutional makeup influences the outcome of political competition. State centralization makes the potential winners of globalization the likely winners of the political competition; decentralization, in contrast, gives an edge to the potential losers. The political competition determines the policy outcome, which, in turn, determines the relative market share of each camp, the relative importance between transaction-specific and marketable instruments, and the resulting degree of market openness. Graph 2 schematizes the main testable hypotheses. Not all of the eleven hypotheses represented there can be systematically tested. Quantitative data only exist for the institutional and market outcome variables (printed in bold). Nevertheless, I review the evidence available for each hypothesis in the assigned numerical order.

GRAPH 2
Hypotheses



Hypotheses 1 and 2: According to these two hypotheses, coalition building and policy outcome vary according to the degree of state centralization. Coalition and policy are qualitative variables. I draw from existing case studies of financial deregulation. Financial deregulation has met political opposition in decentralized settings. The center-periphery cleavage is most visible in the U.S. and German cases - two decentralized countries. At issue in the United States, is the repeal of the Glass-Steagall Act, which prevents large commercial banks from expanding into the securities business. The three financial regulators (the FED, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation) have consistently supported the New York and California banks' demand for repeal, against the opposition of the smaller rural banks and their representatives in Congress.[51] Although the latter have been unable to prevent the erosion of the Glass-Steagall prohibition through the market and the courts, they have successfully blocked all legislative initiatives in Congress, where they have the power to do so.

A similar center-periphery line-up surfaced in Germany about the reform of the German stock market which allowed Frankfurt to break loose from the cartel obligations that had bound it since the War to the seven other regional markets. The "Frankfurt Coalition" included no less than the Federal Finance Minister Waigel along with the four largest banks and Hessen (Frankfurt's *Länder*) against all the other *Länder*.[52] Eventually, in 1992, the Frankfurt coalition overcame the status quo, but at the price of a compromise recognizing the claims of the peripheral coalition.

In Italy - another decentralized country - Law 1/1991 on the financing of medium-sized firms, took a compromise position, providing both for the creation of local securities markets, a solution that was supported by the Chambers of Commerce and a number of regional trade associations, and the creation of a national over-the-counter market, the position that was championed by the Stock Exchange Council and the commercial banks.[53]

At no point did financial deregulation crystallize around a center-periphery cleavage in Britain and France - two centralized countries. In Britain, the deregulation of stock brokerage was promoted by the Bank of England and pitted the corporation of stockbrokers against commercial bankers, insurers, and trust and pension fund managers - all dwellers of The City.[54] In France, the measure was imposed by the state, at times without consultation with banks.[55] In both countries, the political debate was restricted to center-based actors and institutions.

A true anomaly is the deregulation of brokerage in Canada. The Canadian debate proceeded along the center-periphery cleavage, pitting the provincial governments of Ontario and Québec against each other. But while Ontario - the financial center - was opposed to deregulation, Québec - a financial periphery - championed it. The large banks of both provinces rooted for the Québec government against the Ontario government. They won eventually - the Ontario security firms were bought-out by the banks.[56]

Hypotheses 3 and 9: The relative market power of the potential losers and winners of free finance should reflect government policy (hypothesis 3) and, therefore, state centralization (hypothesis 9), since government policy is a reflection of state centralization.

In the financial sector, considered first, one should expect the large commercial banks to gain market share at the expense of local and other banks. Further this trend should be more visible in centralized than in decentralized countries. I present systematic for both hypotheses. I measure the potential winners' and losers' market power by sorting banks into four categories: profit, nonprofit, state, and local:

(1) The profit banks are all the privately-held commercial banks. This category includes the commercial banks that were nationalized, which, for most of them, are now re-privatized, because they have consistently been run like any other profit-oriented bank irrespective of ownership. The central bank is left out of the typology altogether. All profit banks are center banks.

(2) The nonprofit banks, in contrast, are all local banks, or federations thereof. This category includes the savings banks, the credit cooperatives, the mortgage companies that are not managed by the state. Nonprofit banks benefit from legal privileges that allow them to compete with profit banks - they typically pay no (or less) taxes and usually enjoy a state guarantee on their deposits. During the postwar era, they were spared from reserve requirements in all countries but Germany.

(3) The state banks are the postal savings system, three national savings schemes (the British national savings accounts and the share of the French and Belgian national savings system that must be deposited with a central government fund), and the state-run credit banks. The state-run credit banks are not to be confused with the nationalized commercial banks. Whereas nationalization aims at redistributing bank profits, state banking aims at reallocating bank credit. State banks enjoy state borrowing privileges, unlike nationalized banks, which must procure their funds on the market like any

other firm. State banks are usually specialized (one lends to local governments, another to farmers, still another to home owners, or small firms, or to firms in need of venture capital, etc.).[57]

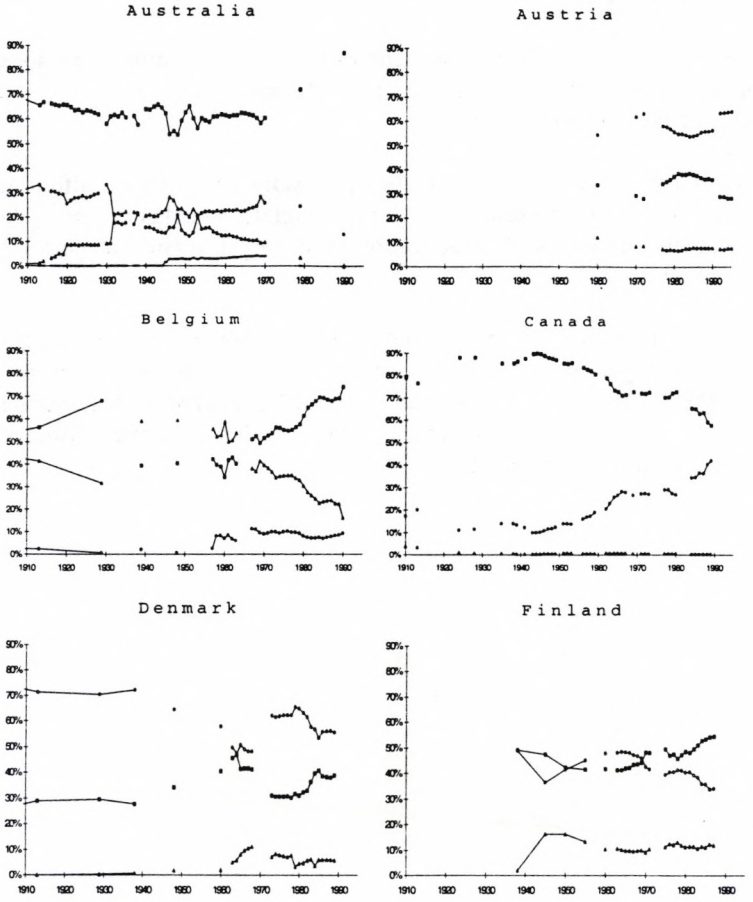
(4) The local banks are profit-oriented commercial banks chartered by local governments. Instances of this category are only found in the U.S., Swiss, and, marginally, Australian federal systems.

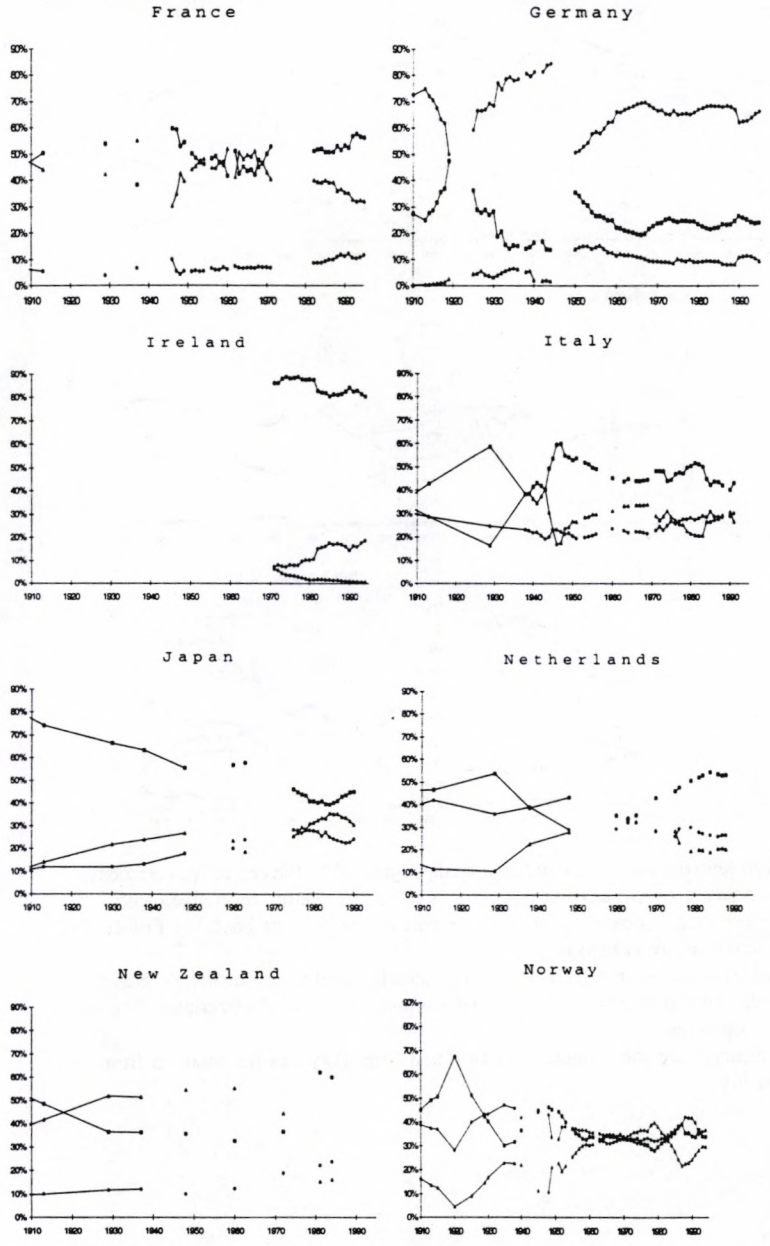
This typology offers the advantages of being broadly comparative, affording long time series, and being useful in tracking the relative market power of the potential winners and losers of globalization - category 1 versus categories 2, 3, and 4 combined.

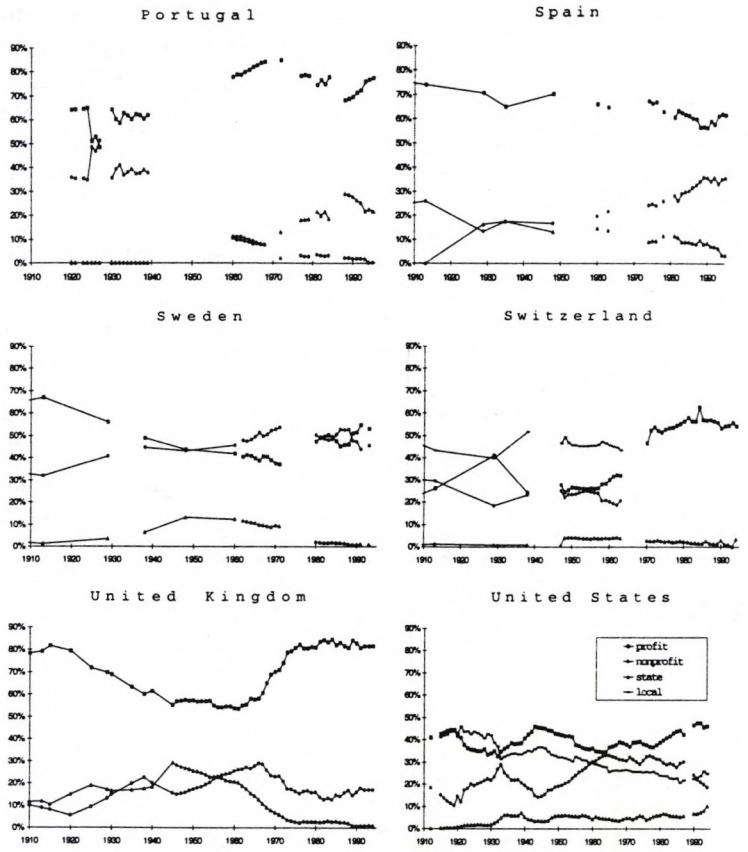
Graph 3 shows the evolution of the relative market shares (calculated in assets) of each category per country. The profit banks continuously lost market share from the 1930s until the 1960s and regained it afterward in Australia, Belgium, Finland, France, the Netherlands, New Zealand, Norway, Sweden, Switzerland, and the United Kingdom.

GRAPH 3

Assets of the Four Banking Sectors in % 1913-1995





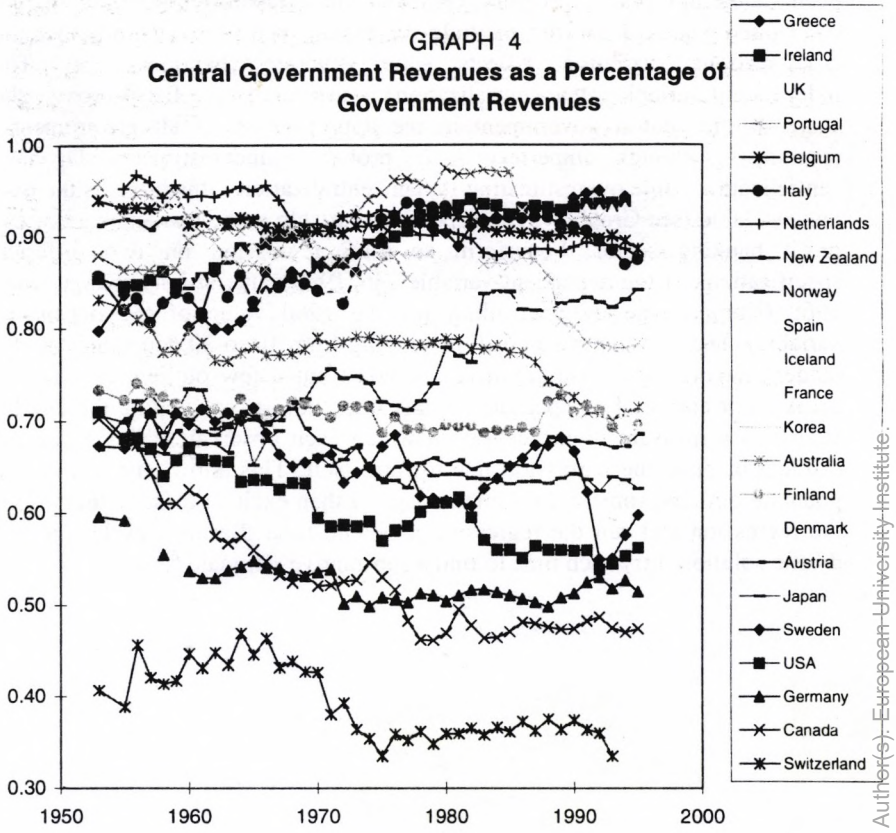


Note: Profit banking sector: commercial banks regulated by the central government.
Nonprofit banking sector: savings banks, mutual credit societies, mortgage banks.
State banking sector: postal savings, all or part of the savings banks in France and Belgium, and state credit banks.
Local banking sector: commercial banks regulated by local governments, such as State banks in the United States, and local and cantonal banks in Switzerland. The four sectors add up to unity.
Sources: Sources are too numerous to be listed here; they can be obtained from the author directly.

This U-shaped trend is not evenly pronounced across countries. It is not even visible in Canada, Denmark, Germany, Italy, Japan, Portugal, Spain, and the United States. I use the multiple regression method to test whether the cross-sectional variation reflects state structure (hypothesis 9). The independent variable (state centralization) is measured by a fiscal proxy - the share of the central government in the appropriation of all governments' revenues. Although imperfect - it probably underestimates Japanese centralization while overestimating Italian centralization - this proxy is the best one available (see Graph 4). The dependent variable is the market share of the profit banking sector. I perform an OLS regression on two different specifications of the dependent variable - its 1990 value and its change since 1960 (simply done by controlling for the 1960 value of the dependent variable). These tests have a small *N*, ranging from 10 to 20 depending on the model, making them case sensitive - it takes but a few outliers to make or break a correlation. I compensate for this limitation by calculating the DFITS statistic - a measure of the degree to which each observation has a deviant residual or pulls the regression line toward itself. This allows me to identify potential outliers, some mild, some strong.[58] I then exclude these outliers from the regression and run the regression a second time. Because exclusion is a drastic solution, I try each time to find a substantive rationale for doing so.

GRAPH 4

Central Government Revenues as a Percentage of Government Revenues



Data Description and Sources: The ratio is that of Central Government Receipts/(Central and Local Government Receipts - Transfers from Central to Local Governments). The sums transferred from the central to the local governments are subtracted from the denominator to avoid double counting. In some cases, the ratio was redefined as (Central Government Receipts - Social Security Contributions)/(General Government Receipts - Social Security Contributions), with General Government including all forms of government. The second ratio was used for years prior to 1960 (Belgium, Canada, Finland, Germany, Greece, Portugal, Sweden, UK, USA), 1962 (Australia), 1963 (France), 1964 (Spain), 1968 (Netherlands, Switzerland), 1970 (Ireland, Japan), 1971 (Austria), 1975 (Norway), 1983 (Iceland, Korea), and throughout the period for which we have data in the case of New Zealand. The main source is OECD National Accounts and the supplementary source, UN Yearbook.

Table 2 shows that both specifications of hypothesis 9 perform well provided that one controls for one additional variable - state banking - and make allowances for one outlier (Switzerland). There is a good reason for controlling for state banking. Historically, state centralization has had two contradictory effects on market centralization depending on the period considered. Until World War I, state centralization mostly worked against all forms of local banking (commercial and nonprofit), strengthening profit banking. In contrast, following the two wars, many centralized states (France, Belgium, the Netherlands, New Zealand) established strong state banking sectors, with the effect of segmenting the credit market and, thus, weakening profit banks.[59] State banking peaked in the 1960s (reaching an average of 20 percent in our sample) and has been gently receding since (dropping to about 10 percent on average in the 1990s). But because this drop has not been uniform, it is desirable to control for its uneven impact on the dependent variable.

TABLE 2

The Asset Share of the Profit Banking Sector as a Function of State Centralization (Hypothesis 9)

	DEPENDENT VARIABLE: Asset Share of the Profit Banking Sector in 1990		
	normal	normal	excluding Switzerland
Regression Number	1	2	3
Constant	.21 (1.34)	.08 (.45)	-.14 (-.66)
Revenue Share of the Central Government 1990	.62 (2.80)**	.49 (2.11)*	.71 (2.82)**
Asset Share of the Profit Banking Sector 1960		.40 (1.71)	.51 (2.25)**
Asset Share of the State Banking Sector 1990	-.93 (-2.96)***	-.70 (-2.11)*	-.68 (-2.21)**
Corrected R^2	.40	.36	.49
Standard Error	.1418	.1352	.1256
Number of observations	17[a]	16[b]	15[c]
OUTLIERS: strong[d]	none	none	
mild[e]	none	Switzerland	

Data Description and Sources: For the dependent variable and the control variables, see Graph 3. For Revenue Share of the Central Government, see Graph 4.

Notes: Values of *t*-statistics are given in parentheses.

[a] Australia, Austria, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, UK, USA.

[b] same as [a] excluding Ireland.

[c] same as [b] excluding Switzerland.

[d] with a DFITS absolute value > sqrt(p), with p the number of right-hand-side variables plus one.

[e] with a DFITS absolute value between sqrt(p) and 2*sqrt(p/n), with n the number of observations.

*,**,*** *t*-values significant at the 1%, 5% and 10% levels respectively.

Switzerland, in contrast, is a real outlier and a problematical case for the present theory. Switzerland features the most decentralized state structure (see Graph 3) along with an increasingly concentrated banking sector (see Graph 3 above).[60] Except for the Swiss case, hypothesis 9 linking market share to state structure in the banking sector is verified: centralization is correlated with both the change in market share of the profit sector over the 1960-1990 period (regression 3) and with its terminal value (regression 1).

It is more difficult to test hypothesis 9 with respect to non-financial firms. The prediction that small firms face relatively higher interest rates than large firms in centralized rather than decentralized countries cannot be tested. Actual rates are unknown. Apparent rates (obtained from pooled balance sheets

by dividing interest payments to financial institutions by the stock of financial debt) are only available for five countries over ten years.[61] Profit data are too ambiguous to serve as plausible proxy, for, besides being influenced by tax laws, lower profit for SMEs may either reflect hardship caused by globalization or, its opposite, since profits need not be as high for a company to attract external funding in a network-based system than in a market-based system.[62] There is longitudinal evidence that small firms' profits over time have declined relative to larger firms' profits in Europe. Gross and net operating profit data for eleven E.U. member states show two distinct periods: small- and medium-size enterprises recorded better performance than larger enterprises before 1987-1988; the relation was reversed after 1988, with the gap increasing significantly in 1994-95.[63] Such evidence is inconclusive, however, for the reversal may have nothing to do with the rise of free finance.

Hypotheses 4 and 10: The importance of transaction-specific relative to marketable instruments is a function of the tax and regulatory policies adopted by governments (hypothesis 4), and thus, by extension, of the relative degree of centralization of the state - centralization should be correlated with lower levels of bank intermediation, decentralization with higher levels thereof (hypothesis 10). There is hardly any doubt that hypothesis 4 holds; wherever governments have liberalized markets, reduced taxes on security gains, and stimulated the creation of pension funds, markets have grown at the expense of traditional banking. Only the more controversial hypothesis 10 needs testing. I use two different specifications of the dependent variable - bank intermediation and institutional investors' economic weight. Bank intermediation measures the relative importance of loans in the financing of a sample of non-financial firms. It is a fraction having for numerator the amount of financial flows coming from bank loans and for denominator the total amount of financial flows. The ratio is a ten-year average (1978-1988). Retained earnings are taken out of the denominator because the relative weight of this post varies widely across countries for reasons having no apparent bearing on our hypothesis.[64]

Although bank intermediation provides a good measure of the importance of bank lending, bank lending does not fully overlap with the category transaction-specific instrument. Equity too can be used to cement long-term relations, as epitomized by the Japanese keiretsu and the French *groupe*. One needs a measure of equity holdings that excludes equity that is held merely for controlling purposes. The value of domestic shares held by institutional investors (insurance companies, investment funds, and pension funds) offers a close approximation of this concept. This value is calculated for 1990 and weighted by GDP. I will use this dependent variable while holding

two other variables constant: (1) stock market capitalization, to clean the residuals from the predictable impact of sheer market size on institutional investors, and (2) the Anglo-Saxon tradition of market-orientation. Although the latter variable has shaky analytical credentials, it is an historical reality which, if left uncontrolled for, makes the results spurious.

The independent variable is the revenue share of the central government in 1980. The method is OLS. The *N* is only 11. In both cases, the test bears on the 1990 (terminal) value of the dependent variable, not on its change over the preceding period, due to the lack of anterior data.

The results exhibit the expected negative relation between state centralization and intermediation *provided that* one treats Canada, but not Germany, as an outlier (regressions 4 and 5, Table 3). The bivariate scattergram (unreported) suggests that the Canadian observation is quite out of line with the other observations, a fact that is confirmed by regressions 4 and 5. Regression 4 includes Canada and generates weak and insignificant results; regression 5 excludes Canada and produces strong results. There is a good reason to treat Canada as an outlier. Canada has a credit market that is considerably more centralized than its state. Historically, the Canadian financial system was established under British rule in the first half of the 19th century, reflecting London's preference for centralization. Although quite centralized under British occupation as well, the Canadian state over time became a prototype of federal decentralization, a trend that brought along an equivalent decentralization of the credit market, but with a rather long lag - there still was a significant discrepancy between state structure and credit market structure in 1980 (contrast Graph 3 and 4 above). No such discrepancy exists in the case of Germany or of any other case.

TABLE 3

The Relative Balance Between Transaction-Specific and Marketable Instruments as a Function of State Centralization (Hypothesis 10)

DEPENDENT VARIABLE	Bank Loans 1978-1988		Institutional Investors 1990	
	normal	excluding Canada	normal	excluding outliers
Regression Number	4	5	6	7
Constant	.82 (2.71)**	1.24 (4.87)***	-.39 (-3.86)***	-.27 (-2.19)*
Stock Exchange Capitalization circa 1989			.53 (7.46)**	.48 (5.53)**
Anglo-Saxon (dummy)			.22 (5.11)**	.20 (3.68)**
Revenue Share of the Central Government 1980	-.67 (-1.60)	-1.18 (-3.48)***		
Revenue Share of the Central Government 1990			.41 (3.48)***	.28 (2.11)*
Corrected R^2	.13	.55	.85	.76
Standard Error	.2146	.1530	.0736	.0595
Number of observations	11[a]	10[b]	18[c]	15[d]
OUTLIERS strong[e]	Canada		UK	
mild[f]	Germany		Australia, Japan	

Data Description and Sources: Bank loans is the simple average for non-financial enterprises of individual years' proportion of total financial flows coming from bank loans, recorded on a net basis, unweighted for inflation, over the period 1978-1988, except for Spain, for which the period is 1982-1988, and Belgium, for which it is 1985-1988; for details on the size of each country sample and further description of the raw data, see OECD Financial Statistics Part 3, various years. Institutional Investors is the value of domestic shares held by insurance companies, investment funds, and pension funds divided by GDP in 1990; for data on the 1990 portfolio composition of institutional investors, see OECD 1997a, pp. 32-34; for data on GDP, see OECD National Accounts. Stock exchange capitalization is the value of domestic shares divided by GDP in 1989 for most countries, 1990 for Australia, France, Belgium the Netherlands, and Italy, 1991 for Denmark and Canada, and 1994 for Japan; for data on stock market capitalization, see OECD Financial Statistics Monthly, Section 2, various years. The datum for Germany was corrected to include the stock exchanges other than Frankfurt's using Lütz's (1996, p. 13) estimate that the Frankfurt stock exchange alone covered almost 75 per cent of all stock market trading in 1990. For "Revenue Share of the Central Government," see Graph 4.

Notes: Values of *t*-statistics are given in parentheses.

[a] Austria, Canada, Denmark, France, Germany, Italy, Netherlands, Norway, Sweden, UK, USA.

[b] Same as [a] excluding Canada.

[c] Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, UK, USA.

[d] Same as [c] excluding the UK, Australia, and Japan.

[e] with a DFITS absolute value > sqrt(p), with p the number of right-hand-side variables plus one.

[f] with a DFITS absolute value between sqrt(p) and 2*sqrt(p/n), with n the number of observations.

*,**,*** *t*-values significant at the 1%, 5% and 10% levels respectively.

In contrast, a strong positive relation exists between state centralization and institutional investors' economic weight, while controlling for market capitalization and Anglo-Saxon tradition (regression 6). Although the DFITS statistic diagnoses three potential cases of outliers (UK, Australia, and Japan), their exclusion from the regression does not significantly affect the results (regression 7).

Hypotheses 5 and 11: Hypothesis 5 suggests that countries that have taken regulatory steps to liberalize their credit markets are also those that are the most open to cross-border capital flows. Although non controversial and not worth the trouble it would take to put it to a rigorous test, hypothesis 5 implies the more counterintuitive hypothesis 11: there is a positive correlation between state centralization and financial openness - decentralized countries, such as the United States, should exhibit relatively un-globalized credit markets.

The prediction in part concurs with some of the European banking profession's views. Anthony Smith writes that, following the 1992 deregulation, the most open Community markets were expected to be those of the UK, Netherlands, Belgium, and France - all four highly centralized countries; the least accessible were expected to be those of Italy, Germany, and Spain - three decentralized countries.[65]

I offer a systematic test of hypothesis 11. The dependent variable (degree of financial globalization) is alternatively measured by international flows and bond activity. The first measure is gross inflows of foreign direct investment (FDI) weighted by GDP. Inflows are preferable to outflows, for the central aim of deregulation is to make domestic assets attractive to foreign investors. Gross flows are preferable to net flows, which are insignificant in most OECD countries, because advanced industrialized countries import about as much capital than they export.

Although the use of flows to measure financial interdependence has been criticized on the ground that, in a world of perfect capital mobility, rates of return would be the same everywhere and capital would then not move at all, the criticism seem irrelevant to the present era.[66] First, greater integration causes international and national markets to be specialized - the former are wholesale markets, the latter retail - with the result that all large domestic transactions have an international counterpart, fueling cross-border capital flows. Second, risks are not perfectly correlated across countries, giving investors an incentive to diversify across countries and thus export capital. Third, and most importantly, capital crosses borders to take advantage of cross-

country differences not just in treasury bond and money market rates, but also in investment opportunities. Were it not the case, one would not observe financial flows between New York and Chicago. And the lower the cost of moving capital, the more of it flows along existing information channels. Information channels, in the presence of integrated product markets, run along sectoral lines, across geographic borders.[67] Therefore, the freer product and financial markets are, the more direct and portfolio investment should cross borders.

The use of FDI inflows is thus problematic for a different reason. It only measures direct, not portfolio, investment. I introduce a second measure of internationalization - the proportion of corporate bonds issued abroad.[68] The numerator is the value of corporate bonds issued on the Euro- and foreign markets, whereas the denominator is the value of corporate bonds issued on all markets - Euro, foreign, and domestic.

A required control variable is the Anglo-Saxon tradition. The Anglo-Saxon head-start in the development of securities markets must be taken out of the dependent variable for its remaining variance to show the impact of globalization. Another necessary control variable is export dependence. Exporting a sizable proportion of its national product makes an economy a likely candidate for financial internationalization. Export dependence should also capture the variance in the dependent variable caused by the natural synergy existing between financial and trade openness, thereby allowing the other variables (the centralization variable and the Anglo-Saxon dummy) to capture the remaining variance - the one that is being theorized about here. A last control variable is country size, to guard against the risk that federal structure and low dependence on the world financial market are not a mere reflection of large size.

I first perform a series of cross-sectional OLS regressions at discrete points in time using FDI as dependent variable. The test is successively administered in the sixties, seventies, and eighties. Globalization being a recent phenomenon, the coefficient for the institutional variable and the Anglo-Saxon dummy should gain in significance over time. This expectation is borne out by the findings (see Table 4). High FDI inflows is correlated with none of the right-hand side variables in the sixties (regressions 8 and 9). Then, as globalization takes off in the seventies, all the variables become relevant, with the exception of size, and so remain in the eighties (regressions 10 to 13). Size is insignificant across specifications. Although there is no good reason to exclude the potential outliers in regression 8 and 10, exclusion has no impact on the findings in either case.

Such is not true of regression 12. To get a sense of what is happening, I draw the partial regression plot for the institutional variable (see Graph 5).[69] The plot shows that Belgium is no real outlier, but Switzerland and Ireland are: Switzerland is an outlier for the same reasons as those developed when discussing the results of regression 2. Ireland is an outlier due to an exogenous shock in the dependent variable. Overall, hypothesis 11 seems to hold. Centralized institutions and the Anglo-Saxon market-oriented tradition favor financial globalization. More generally, product globalization and financial trade globalization are no surrogate. Although, the Export/GDP variable is correlated with the FDI/GDP variable in most regressions, the two variables do not overlap. They are not interchangeable proxies for globalization, but two dimensions of globalization between which state institutions, after controlling for Anglo-Saxon background, seem to drive a wedge.

TABLE 4
Financial Openness as a Function of State Centralization (Hypothesis 11)

DEPENDENT VARIABLE:	FDI Inflows Weighted by GDP						International Bonds
	1961-1970		1971-1980		1981-1990		1990-1996
	normal	Excluding outliers	normal	excluding outliers	normal	excluding outliers	normal
Regression Number	8	9	10	11	12	13	14
Constant	.01 (.10)	-.035 (-.78)	-.18 (-3.62)***	-.19 (-4.30)***	-.15 (-1.04)	-.250 (-2.28)**	-.95 (-1.54)
Export/GDP 1961-1970	.04 (.21)	.21 (1.55)					
Export/GDP 1971-1980			.21 (3.16)***	.23 (3.69)***			
Export/GDP 1981-1990					.17 (1.42)	.24 (2.41)*	
Export/GDP 1990-1995							.33 (.49)
log GDP 1960	-.02 (-1.21)	.002 (.14)					
log GDP 1971			.002 (.28)	.002 (.30)			
log GDP 1982					.007 (.45)	-.006 (-.66)	
log GDP 1992							.03 (.49)
Anglo-Saxon	.07 (2.06)*	.03 (.68)	.07 (5.71)***	.08 (6.43)***	.05 (1.33)	.13 (5.47)***	
Stock Market							.62

TABLE 4
Financial Openness as a Function of State Centralization (Hypothesis 11)

DEPENDENT VARIABLE:	FDI Inflows Weighted by GDP						International Bonds
	1961-1970		1971-1980		1981-1990		1990-1996
	normal	Excluding outliers	normal	excluding outliers	normal	excluding outliers	normal
Regression Number	8	9	10	11	12	13	14
Capitalization c. 1989							(2.65)**
Revenue Share of the Central Government 1960	.10 (.87)	.04 (.37)					
Revenue Share of the Central Government 1970			.21 (4.39)***	.21 (3.80)***			
Revenue Share of the Central Government 1980					.17 (1.83)*	.31 (4.77)***	
Revenue Share of the Central Government 1990							.88 (2.33)*
Corrected R^2	.12	.25	.84	.91	.19	.75	.39
Standard Error	.0455	.0270	.0218	.0173	.0677	.0356	.1927
Number of observations	13[a]	11[b]	16[c]	13[b]	19[d]	16[b]	11[e]
OUTLIERS: strong[f]	Australia, Germany		none		Ireland		UK, Netherlands
mild[g]	none		Canada, Australia, Germany		Belgium, Switzerland		Switzerland, Japan

Data Description and Sources: FDI inflows is the cumulative inflows of direct investment weighted by GDP over the indicated period; see Graph 1. "Export/GDP" is the ratio of total exports to GDP averaged over the indicated period (OECD National Accounts). Log GDP is self-explanatory. International Bonds is a ratio with, for a given country, the value of Eurobonds and foreign bonds issued as numerator and the total amount of corporate bonds (Euro, foreign, and domestic) issued as denominator. The sources are OECD Financial Market Trends and Financial Statistics Monthly. All other variables are defined in Graph 4 and Tables 2 and 3.

Notes: Values of *t*-statistics are given in parentheses.

[a] Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Spain, Sweden, UK, USA

[b] Same as preceding column minus outliers.

[c] Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Spain, Sweden, UK, USA.

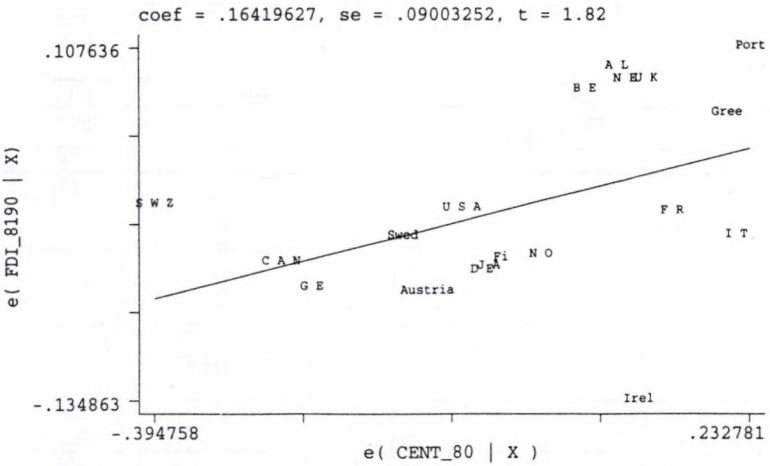
[d] Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, USA

[e] Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Spain, Switzerland, UK, USA.

[f] with a DFITS absolute value > sqrt(p), with p the number of right-hand-side variables plus one

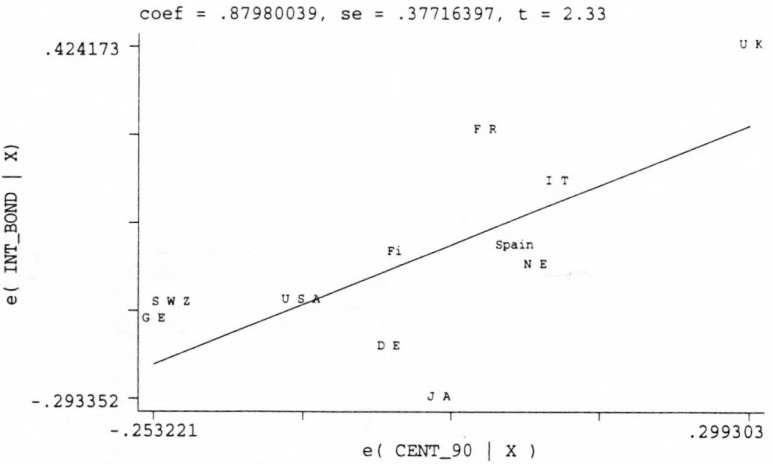
[g] with a DFITS absolute value between sqrt(p) and 2*sqrt(p/n), with n the number of observations.

*,**,*** *t*-values significant at the 1%, 5% and 10% levels respectively.



GRAPH 5: Partial Re. Plot, State Centralization Var, Re. 12, Ta. 4

I perform the same test, substituting international bond issues for FDI inflows (regression 14).[70] Although the findings conform to expectations, they are plagued with a slew of potential outliers - a common occurrence in the presence of a very low *N*. The examination of the partial regression plot for the state centralization variable is more appropriate than a re-run of the regression without the problematic observations. Such examination (Graph 6) reveals no anomaly; surely the UK observation is pulling the regression line through itself, but the other countries are not so much out of line, so to speak, that the results should be dismissed as spurious. This last test shows that hypothesis 11 is equally observable when financial globalization is proxied with securities or with FDI.



GRAPH 6: Partial Re. Plot, State Centralization Var., Re. 14, Ta. 4

I overcome the potential outlier problem plaguing the low-*N* cross-sectional regressions 8-13 by performing a pooled time-series/cross-section analysis on 15 countries over 25 years (*N* = 375). Preliminary tests (unreported here) indicated that the residuals are normally distributed (and the model, thus, correctly specified), but successively detected the three banes of groupwise heteroscedasticity, contemporaneous heteroscedasticity, and serial correlation.[71] The fact that the number of time periods (25) is greater than the number of panels (15) justifies the use of feasible generalized least squares (FGLS), correcting for the problems mentioned, serial correlation notably, through the use of an autoregressive (AR1) coefficient parameter for the error term common to all panels. Two variations of this model are run, one with Beck and Katz's (1995) panel corrected standard errors, the other without, on the grounds that the number of time periods is such that either method could a priori be justified. To the variables already used in regressions 8-13, I added a trend variable varying exponentially - $(t\text{-}1969)^2$, with t the year of the observation - to capture the overall growth in financial interdependence.

The findings confirm the statistical significance of all four variables (see Table 5). The coefficients are consistent and correctly signed across specifications. Although statistical significance is consistently lower with panel-corrected standard errors, it still reaches standard levels. Once again, product globalization is correlated with financial globalization but it leaves an unexplained residual - cases in which export-orientation and financial dependence stand at relatively opposite corners of the value range. After

controlling for the Anglo-Saxon tradition, this unexplained residual is consistently found to be correlated with state centralization.

TABLE 5
FDI Inflows as a Function of State Centralization. Pooled Models (Hypothesis 11)

DEPENDENT VARIABLE: FDI Inflows Weighted by GDP		
Regression Number	15	16 (Panel Corrected)
Constant	-.009 (-6.70)***	-.014 (-2.71)***
Export/GDP	.021 (11.10)***	.030 (5.44)***
Anglo-Saxon (dummy)	.006 (5.93)***	.006 (3.250***
Trend	.000004 (7.59)***	.00001 (2.71)***
Revenue Share of the Central Government	.010 (5.39)***	.012 (1.85)*
Log Likelihood	1915.743	1901.902
$Chi^2(4)$	173.69***	42.00***
No. of observations	375[a]	375[a]

Data Description and Sources: The dependent variable is the yearly inflows of direct investment weighted by GDP. Trend equals $(t\text{-}1969)^2$, with t the observation year. All other variables are presented in Graph 4 and Tables 2-4.

Notes: The method is Feasible Generalized Least Squares, correcting for heteroscedasticity and correlation across panels, as well as for a common AR (1) coefficient for all panels. The reported coefficient estimates are GLS estimates in regression 15 and Ordinary Least Squares estimates with panel-corrected standard errors in regression 16.Values of z-statistics are given in parentheses.

[a] 15 countries over 25 years. The countries include Australia, Austria, Belgium, Canada, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Portugal, Sweden, UK, and USA The time period is 1970-1994.

*,**,*** z-values significant at the 1%, 5% and 10% levels respectively.

Hypothesis 6, 7, and 8: Market outcomes should be correlated with one another - a large profit sector should go hand in hand with a low level of bank intermediation and a high degree of financial openness. Correlation coefficients are calculated twice on the largest sample common to all variables, the first including the low-*N* international bond variable, a second excluding this variable. All coefficients are above the 0.50 benchmark, except for that between intermediation and institutional investors, two measures of the relative importance of transaction-specific and marketable instruments which were deliberately selected for their complementarity rather than their similarity.

TABLE 6
Pearson Correlation Coefficients Between Market Outcomes (Hypotheses 6, 7, and 8)

	profit banking	intermediation	institutional investors	FDI inflows
N=7				
intermediation	-.66			
institutional investors	.88	-.39		
FDI inflows	.76	-.52	.74	
international bonds	.92	-.58	.80	.74
N=11				
intermediation	-.66			
institutional investors	.85	-.38		
FDI inflows	.73	-.50	.74	

Data Description and Sources: All variables are described in Graph 4 and Tables 2-5. The coefficients are calculated on the two largest common samples, the first one including the bond variable, the second excluding it. The countries included in the first sample are France, Germany, Italy, Japan, the Netherlands, UK, and USA; the countries included in the second sample are the same plus Austria, Canada, Norway, and Sweden.

Conclusion

Free trade and free finance are no surrogate measures of globalization. Although free trade and free finance have in common the effect of increasing competition and compelling market actors to adopt new profit-maximizing strategies, these strategies radically differ - while firms adjust to globalization in product markets through product differentiation and flexible production, banks adjust to globalization in capital markets through product standardization and amalgamation. From this divergence results a mismatch between the supply and demand of financial instruments, with firms demanding more customized, specific instruments, and banks offering more standardized, marketable instruments.

This mismatch cannot be solved through the price mechanism but instead calls for a political solution. Several ones are a priori possible. First, governments may insist on free trade and free finance, pressing firms to acquire the size and visibility that would give them direct access to financial markets. Second, banks and firms could try to reduce investment uncertainty by restricting competition in product markets. A protectionist revival would reconcile firms' demand with marketable financial instruments. Third, rather than free trade, governments may choose to discontinue free finance, thereby reducing financing uncertainty for banks and allowing them to customize their loans to the needs of firms producing for an open world market. Fourth, governments could dispose of both free trade and free finance.

The first option was pursued by Britain under the gold standard in response to a similar dual trend toward free trade and free finance with the dismal consequences for small and medium-size enterprises that Zeitlin has chronicled. It is also being followed nowadays by centralized countries with consequences that are still to be assessed. The second option was followed by the rest of the world under the gold standard. The role of banks such as J.-P. Morgan in the United States and the Grossbanken in Germany in cartelizing entire sectors of industry is well documented. The third option is being followed today by most decentralized countries. The fourth option was pursued by decentralized countries under the gold standard.[72]

Why are different options pursued in different periods and by different countries? This essay offers a partial answer to this question, one concerning free finance. The argument is that decentralized state structures empower the potential losers of free finance (the small and the local) enough to check its most undesirable effects. Centralized states, in contrast, empower the potential winners of free finance (the big and centrally-located). Although the present

argument is a step ahead of the current literature, which has paid little attention to the wide variation between countries, and although the present argument seems to find empirical support in both the gold standard and present periods, it remains a partial-equilibrium argument, holding trade politics constant in the determination of finance politics. Yet, the politics of trade and finance may be linked, and identifying the ways in which they are is a conceivable direction for future research.

DRAFT No 4
September 1998

Daniel Verdier
Department of Social and Political Sciences
EUI
Via dei Roccettini 9
I-50016 San Domenico di Fiesole (FI)
verdier@datacomm.iue.it

NOTES

[1] For comparisons of present levels of openness with those obtaining under the Gold Standard, see Bairoch 1996 and Zevin 1992.

[2] In trade, domestic competition has preceded international competition by almost a century. In banking and finance, the two steps have been taken simultaneously, making them empirically indistinguishable. Domestic competition is a prerequisite for international competition, but the reverse is not true.

[3] For a review of the literature, see Cohen 1996.

[4] See, among others, Cox 1993, Gill and Law 1993, Goodman and Pauly 1993, O'Brien 1992, Sinclair 1994, and Strange 1986.

[5] See Boyer and Drache 1996, Cerny 1989, Coleman 1993, Deeg and Lütz 1996, Lütz 1996, Moran 1994, Sobel 1994.

[6] Systematic cross-national analyses include Epstein and Schor 1992, Obstfeld 1995, and Quinn and Inclán 1997.

[7] For existing works already pursuing this direction, see Frieden and Rogowski 1996, Garrett 1995, and Haggard and Maxfield 1996.

[8] Admittedly, one could model financial globalization differently, making it an exogenous trend while treating political institutions as an endogenous variable (see Frieden and Rogowski 1996). The present model is thought to be more desirable to study the politics of globalization because it magnifies the role of political institutions at the expense of economic endowments. For a more extensive discussion, see Verdier 1998, pp. 3-4.

[9] The classic account is Riesser 1911, p. 725. On the more general role played by banks in monitoring firms' investment, see Diamond 1984.

[10] For Japan, see Aoki and Patrick 1995; for France, Hancké and Cieply 1996.

[11] See Bagnasco 1977; Herrigel 1996.

[12] A third textbook case of network allocation of capital—spotted in France in the 1960s-1970s— is state banking. A state-banking network involves a local firm, the local representative, a local state official, and one or several central administrators. For references, see Verdier FORTH.

[13] See Helleiner 1994, pp 88, 93. The Euromarkets became especially important in the recycling of the petrodollars following the oil shocks of the 1970s.

[14] See Green 1997 and Davis 1995. For data on households' financial holdings covering seven OECD countries for the period 1976-1990, see Rybczynski 1994, p. 215.

[15] See Reinicke 1995.

[16] The conflicts of interests surrounding each "Big Bang" are chronicled, for Britain, by Moran 1994, for Japan, by Holt Dwyer 1997, for the U.S., by Sobel 1994, for Canada, by Harris 1996, for Australia, by Ackland and Harper 1992, for France, by Cerny 1989, and for Germany, by Lütz 1996.

[17] I am not arguing that OECD bank profits have actually declined as a result of globalization—they did throughout the 1980s, and then recovered in the 1990s—but that banks must change their financing and investment strategy in order to maintain past profit margins.

[18] For instance, Deutsche Bank acquired Morgan-Grenfell, Dresdner acquired Kleinwort-Benson, Commerz acquired Hambro, ING acquired Barings, SPC acquired Warburg, Crédit Suisse acquired First Boston.

[19] On the securitization of bank loans, see Thompson 1995.

[20] For econometric evidence that the process of deregulation in OECD countries over the 1981-1990 period has increased banking concentration, see Cerasi 1996. Cerasi argues that tougher competition leads to lower profits, driving many firms out of the industry and thus increasing concentration.

[21] See Smith 1992, p. 137.

[22] One should note, however, that some economists have argued that the very fact that a bank endorses a firm signals to others that the firm is worth investing. De Long (1991) has argued that reputation explained J.-P.Morgan's success in placing bonds. These results either lack robustness (the signalling scenario is plagued with externalities, making no loans or multiple loans with no monitoring two additional and equally plausible equilibria) or admit of alternative interpretations (see Sabel's emphasis on monopolistic control in his comments on De Long's piece).

[23] Porter 1992, p. 69. There are exceptions, involving U.S. public-employee funds; see Davis 1995, p. 192.

[24] For instance, Michael Porter writes that "pure costs advantages are more vulnerable because new product designs or other forms of differentiation can eliminate a cost advantage in delivering old ones" (1990, pp. 51, 64). Product differentiation is viewed by economists as the logical response to the profit uncertainty caused by the possibility of price competition. Hence, the greater the price competition, the greater the incentive for product differentiation. See Beath and Katsoulacos 1991, p. 6.

[25] See Piore and Sabel 1984.

[26] See Aoki 1988, Sabel 1989, and Cooke and Morgan 1994.

[27] See Grossman and Helpman 1991, pp. 16, 57, 335.

[28] See OECD 1995, p. 21.

[29] Porter 1990, p. 158.

[30] Krugman 1991.

[31] See Dunning 1988.

[32] See Deeg 1996, Sabel 1989, Saxenian 1994, and Storper 1995, p. 210.

[33] Amin and Thrift 1992, p. 576.

[34] Tödtling 1994, p. 74.

[35] There exists a broad literature on that issue. Partisans of the class (factor) taxonomy include Rogowski 1989, whereas supporters of the sectoral categorization include Magee 1980, Frieden 1991, and Frieden and Rogowski 1995 among others. Alt and Gilligan 1994 and Verdier 1995 investigate the conditions of application of each approach. Gilligan 1997 rejects all cleavages, pointing instead to the firm as unit of political action. Most of this literature bears on trade and monetary policy. In banking, Maxfield 1990 points to a zero-sum game between the private and public banking sectors, while Deeg FORTH chronicles the secular rivalry between the profit and nonprofit banking sectors in Germany. The literature on capital mobility features authors who emphasize territorial rivalries (Krugman 1991, Rogowski 1997) and authors who stress the labor-capital conflict (Garrett 1996, Rodrik 1997, Quinn and Inclan 1997).

[36] See, among others, Kurzer (1993, p. viii), Cohen (1996, p. 286).

[37] See Davis 1995, p. 171.

[38] Zeitlin 1992, p. 290.

[39] Zeitlin 1995, p. 105.

[40] See Ackland and Harper 1992, p. 50.

[41] The point about the nonprofit banks' option to become more competitive is made by Richard Deeg (1996, p. 51).

[42] For systematic evidence that the Left in general is as supportive of financial globalization as the Right, see Garrett 1995 and Quinn 1997. For a convincing argument for why this ought to be the case, see Rodrik 1997.

[43] Not only are the two issues (resistance and indemnification) different, but they are not as closely linked as standard cost-benefit economics would expect them to be, given the constitutional incapacity of government (including the Left, since it cannot guarantee its re-election) to credibly commit to schemes of full indemnification for the victims of a policy

otherwise deemed as more efficient for society as a whole. On the tricky issue of government commitment, see Frieden and Rogowski 1996, p. 44.

[44] See Mény 1998.

[45] Populist parties are not to be confused with regionalist parties, such as the Italian *Lega Nord*, the Belgian *Volksunie*, the *Bloc Québécois*, and the Catalan and Basque parties, who tend to articulate the preferences of cosmopolitan individuals in extroverted, upwardly mobile regional economies. See Tossutti 1998. Although represented in national elections, these parties are mostly active in local governments.

[46] See Moran 1994, and also Coleman 1993, Lütz 1996, and Cerny 1989.

[47] On the importance of Brussels for sub-national governments and an assessment of the extent of their lobbying, see Marks, Nielsen, Ray and Salk 1997.

[48] On the role of the courts in the gradual sidestepping of the Glass-Steagall ban, see Reinicke 1995, p. 102. On the more general role of the European Court of Justice in fostering "competitive regulation" between EU members, see Scharpf 1996.

[49] Other conceivable blocking positions include the maintenance of the favorable tax treatment of debt against equity financing; the defense of the state-run social security system against the encroachments of private pension plans; the protection by law of company secrecy to the effect of maintaining banks' comparative advantage over markets as a source of finance; the maintenance of laws insuring close bank-firm relations—for instance, laws recognizing creditors a say in management.

[50] Even though such a commitment would be hard to keep in the event of a severe and drawn out business downturn.

[51] See Reinicke 1995, pp. 57-123.

[52] See Lütz 1996.

[53] See Mondello 1994, p. 198.

[54] See Moran 1991, and Sobel 1994.

[55] According to Cerny 1989, p. 183. Coleman (1993) offers a concurring opinion in his survey of French banking reforms.

[56] See Harris 1996.

[57] On state banking, see Verdier FORTH.

[58] I use standard definitions of strong and mild. A strong potential outlier is one with a DIFTS value superior to what is known as the "high cutoff "point—the square root of p, with p being the number of variables plus one (the constant). A mild potential outlier is one whose

DFITS statistics is situated between this high cutoff and the so-called "low cutoff" point—2*square root of p/n, with n the number of cases. See Bollen and Jackman 1990.

[59] See Verdier FORTH.

[60] The outward orientation of Swiss banks is not new, but already existed in 1913.

[61] In the BACH data bank; see European Commision 1997, p. 29. The OECD data bank does not differentiate companies by size.

[62] Hence, net profit ratio has consistently been higher in the U.S. over the 1984-1995 period than in Europe or in Japan; see European Commission 1997, p. 24.

[63] European Commission 1997, p. 22.

[64] Cross-country variations in retained earnings usually reflect variations in firms' profit strategy, in turn influenced by variations in tax treatment and ownership—insiders are generally more likely to plow the profits back into the company than outsiders.

[65] Smith 1992, p. 154.

[66] On measuring capital mobility, see Epstein and Schor 1992, Hallerberg and Clark 1997, Obstfeld 1995, and Quinn and Inclán 1997.

[67] This paragraph draws from Krugman 1987, p. 126.

[68] Data on equity are too sparse to be included.

[69] The partial regression plot is, according to Bollen and Jackman (1990: 260) "the multivariate analog of the bivariate scattergram." Each plot generates a coefficient and a fit that are equal to the coefficient and fit of the dependent variable against the chosen right-hand-side variable, while simultaneously controlling for the effect of the other right-hand-side variables on the dependent variable.

[70] Data limitations restrict its calculation to 12 countries over the period 1990-1996.

[71] The error terms being normally distributed, I used the Lagrange multiplier statistic to test the assumptions that the error term is homoscedastic and rejected it. Using likelihood ratio tests, I also found the assumptions of no contemporaneous correlation and no serial correlation violated.

[72] See Verdier 1998.

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